LIBRARY
SUPREME COURT, U. S.

FILED
JUN 4
JOHN T. FEY, Clerk

No. 989

In the Supreme Court of the United States

OCTOBER TERM, 1957

MONTE MANSFIELD AND ELEANOR MANSFIELD,
PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
HARRY BAUM,
GRANT W. WIPRUD,
Attorneys,
Department of Justice, Washington 25, D. C.

INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	1
Statutes and regulations involved	2
Statement	2
Argument	4
Conclusion	10
Appendix	11

CITATIONS

Cases:	
Barnes v. *United States*, 22 F. Supp. 282	9
Commissioner v. *Phipps*, 336 U. S. 410	8
Commissioner v. *Sansome*, 60 F. 2d 931, certiorari denied, 287 U. S. 667	7, 8, 9
Mandel v. *Commissioner*, 5 T. C. 684	9
McClintic, Estate of v. *Commissioner*, 47 B. T. A. 188	9
Murchison's Estate v. *Commissioner*, 76 F. 2d 641	7, 8
Reed Drug Co. v. *Commissioner*, 130 F. 2d 288	7, 8, 9
Robinette v. *Commissioner*, 148 F. 2d 513	9
United States v. *Kauffmann*, 62 F. 2d 1045	7, 8
Statutes:	
Internal Revenue Code of 1939:	
Sec. 112(b) (26 U. S. C. 1952 ed., Sec. 112(b))	2, 4, 5, 8, 11
Sec. 112(g) (26 U. S. C. 1952 ed., Sec. 112(g))	2, 13
Sec. 115(a) (26 U. S. C. 1952 ed., Sec. 115(a))	2, 4, 13
Miscellaneous:	
Treasury Regulations 111, Sec. 29.115–11	2, 6, 14
Treasury Regulations 118, Sec. 39.115(a)–3(a)	6

467297—58——1

In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 989

MONTE MANSFIELD AND ELEANOR MANSFIELD,
PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The Opinion of the Court of Claims (Pet. App. B), is reported at 159 F. Supp. 346.

JURISDICTION

The decision below was entered on March 5, 1958. (Pet. App. B, pp. 1, 19.) The petition for certiorari was filed on May 8, 1958. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1255 (1).

QUESTION PRESENTED

Whether the court below erred in holding that, in the circumstances of this case, a corporation's ac-

cumulated earnings and profits available for dividend distributions were not diminished merely because in a tax-free exchange it substituted stock of a newly formed subsidiary for some of its physical assets.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statute and regulations are Sections 112 (b) and (g) and 115 (a) of the Internal Revenue Code of 1939, and Section 29.115–11 of Treasury Regulations 111. These are set forth in the Appendix, *infra*, pp. 11–15.

STATEMENT

The material facts, as found by the Court of Claims (Pet. App. B, pp. 1–3, 12–19), may be summarized as follows:

Taxpayers are husband and wife. Prior to 1948 the taxpayer-husband operated a Ford automobile agency in Tucson, Arizona, as a sole proprietor. On January 1, 1948, taxpayers formed Monte Mansfield Motors, an Arizona corporation, and transferred to it the agency business and the land and building owned by taxpayers individually and used in the conduct of the business. In exchange, taxpayers received substantially all the stock of the corporation. On December 31, 1948, the name of the corporation was changed to Monte Mansfield Investment Company. (Pet. App. B, pp. 12–13.)

On January 1, 1949, Monte Mansfield Investment Company (hereafter called Investment) had assets in excess of liabilities (including depreciation reserves) of $157,411.67, which included accumulated

earnings and profits of $31,336.92. (Pet. App. B, p. 13.)

On January 1, 1949, taxpayers organized a new corporation, Monte Mansfield Motors (hereafter called Motors), as a subsidiary of Investment. Motors issued to Investment all of its capital stock, amounting to 312 shares. In exchange Motors received a portion of Investment's assets and assumed certain liabilities of Investment. The assets thus received exceeded liabilities assumed by $31,224.10, and consisted of cash, notes and accounts receivable, inventories of cars, trucks, parts and materials, machinery and equipment, office furniture and fixtures, and service cars. The par value of the Motors stock received by Investment, at $100 per share, was $31,200. The difference of $24.10 between this amount and the amount of net assets received by Motors was carried on the books of Motors as paid-in surplus. Investment retained the land and building which had been part of its initial assets, plus prepaid insurance on the building. It also continued to carry on its books the full amount of earnings and profits it had accumulated as of the date of the exchange. The parties agree that the exchange thus effected between Investment and Motors was tax-free under Section 112 (b) of the 1939 Code. (Pet. App. B., pp. 1–2, 13–15.)

The capital stock of Motors, received by Investment in the above-described exchange, was retained by Investment until its liquidation in 1951. From January 1, 1949, to July 1, 1951, Investment's only source of income was the building rent paid to it by its sub-

sidiary, Motors, at an annual rate of $21,600. For this period, according to its books and records, Investment had net earnings after taxes of $1,572.37. As of July 1, 1951, Investment was liquidated and all its assets, including Motors stock, were distributed to taxpayers. (Pet. App. B, pp. 15–17.)

Taxpayers filed a joint return for 1951, electing under Section 112 (b) (7) of the 1939 Code to treat the liquidation of Investment as a nontaxable exchange, and having so elected were required by that section to report as dividends their ratable share of Investment's earnings and profits available for distribution as dividends. Taxpayers did not report as a dividend, however, any part of Investment's earned surplus as of the time Motors was created ($31,336.92) but reported as such only the amount ($1,572.37) accumulated by Investment subsequent to the creation of Motors, *i. e.*, from January 1, 1949, to July 1, 1951. (Pet. App. B, pp. 3, 17.)

The Commissioner determined a deficiency on the ground that the earnings and profits of Investment taxable to taxpayers as a dividend under Section 115 of the 1939 Code included Investment's earned surplus when Motors was created as well as its subsequent accumulation of earnings and profits. (Pet. App. B, pp. 3, 19.)

ARGUMENT

1. The question here is whether, when Investment was liquidated on July 1, 1951, its accumulated earnings and profits included the entire amount of its

earned surplus as of the end of 1948.[1] The answer turns upon the effect of the tax-free exchange between Investment and its newly-organized subsidiary, Motors, which occurred on January 1, 1949. Investment transferred to Motors a portion of its business properties and liabilities in exchange for all of Motors' capital stock. The Court of Claims held (Pet. App. B, p. 12) that this exchange did not effect any diminution in Investment's accumulated earnings and profits; more particularly, that no rule of law required an allocation of Investment's earned surplus between Investment and Motors and that, in the absence of such a rule of law, the circumstances of the case did not justify any such allocation. We submit that the ruling of the Court of Claims is clearly correct.

The business assets transferred by Investment to Motors had a net book value in excess of liabilities transferred of $31,224.10. All but $24.10 of this amount was reflected in the par value of the Motors stock issued to Investment ($31,200), the nominal difference being carried on Motors' books as paid-in surplus. Investment retained the Motors stock as part of its own assets from the date of receipt until it was liquidated two and one-half years later. Thus, it is evident that the exchange resulted in a mere sub-

[1] As appears from the statement, this question arises because taxpayers invoked the nonrecognition provisions of Section 112 (b) (7) of the 1939 Code (Appendix, *infra*, pp. 11–13), with respect to the liquidation of Investment. Section 112 (b) (7) (E) (i) provides, as to noncorporate shareholders, that their ratable shares of the earnings and profits of the corporation accumulated after February 28, 1913, shall be taxed to them as a dividend, as of the date of liquidation.

stitution of assets in the hands of Investment. As the Court of Claims emphasized (Pet. App. B, p. 7)—

> the stockholders of Investment remained the stockholders of Investment after the tax-free exchange on January 1, 1949, and their interest in Investment was unaffected * * *. What has happened here is that Investment * * * changed the composition of its assets and, in place of certain physical assets, it had after the 1949 exchange the 312 shares of Motors' stock which had a value identical to the assets transferred to Motors. The net worth of Investment was the same after the 1949 exchange as it was immediately prior thereto.

Under these circumstances there is surely no ground for any diminution of Investment's accumulated earnings and profits by allocation thereof between Investment and Motors. Taxpayers do not contend that the relevant statutory provisions compel such a result. As for the applicable provision of Treasury Regulations,[2] it merely provides that, where there is an intercorporate tax-free exchange, there shall be a "proper" adjustment and allocation of the earnings or profits of the transferor, as between transferor and transferee corporations. What is "proper" obviously depends on the particular facts of each situation; hence the regulation contemplates only such adjustment and allocation, if any, as may be warranted by the facts.

---

[2] Section 29.115–11 of Treasury Regulations 111. (Appendix, *infra*, pp. 14–15.) Taxpayers invoke Section 39.115(a)–3(a) of Treasury Regulations 118, which is the successor provision to Section 29.115–11 and which is identical in language, but which is applicable only to tax years beginning after December 31, 1951.

And none is warranted here, for the reasons pointed out in the opinion below.

2. There remains for consideration taxpayers' contention that the instant ruling of the Court of Claims is in conflict with a succession of decisions, beginning with *Commissioner* v. *Sansome,* 60 F. 2d 931 (C. A. 2d), certiorari denied, 287 U. S. 667. According to taxpayers, these decisions have evolved a rule of law, independent of statute, which requires allocation of earnings and profits in *every* intercorporate tax-free exchange, without regard to circumstances or end result. We submit that the alleged conflict does not exist; that none of the decisions invoked by taxpayers stands for the broad and inflexible rule of law which taxpayers contend for here.

Sansome was a case in which corporation A, having a large balance of earnings and profits, transferred all of its assets and liabilities to corporation B, whereupon B issued its stock to the stockholders of A in exchange for the stock of A, and A was liquidated. Under these circumstances, the court held that the accumulated earnings and profits of A were inherited by B as a matter of law. Similar results were reached in *United States* v. *Kauffmann,* 62 F. 2d 1045 (C. A. 9th); *Murchison's Estate* v. *Commissioner,* 76 F. 2d 641 (C. A. 5th); and *Reed Drug Co.* v. *Commissioner,* 130 F. 2d 288 (C. A. 6th). In all of these cases, the transferor corporation transferred all of its assets to another corporation and was liquidated, the stockholders of the transferor becoming the stockholders of the transferee. Obviously, if the earnings and profits of the transferor did not pass

to the transferee, they would escape taxation altogether as dividend income, and it was the prevention of such escape which constituted the proper basis for the holding in these cases that the transferee corporation inherited the earnings and profits of the transferor. *Commissioner* v. *Phipps,* 336 U. S. 410. The decision below is in harmony with the prevention-of-tax-avoidance rationale of the *Sansome* line of decisions, as explained by this Court in *Phipps.* To hold, as taxpayers contend, that a portion of Investment's earnings must as a matter of law be treated as Motor's earnings, would permit Investment's stockholders (taxpayers), while electing to take the nonrecognition benefits of Section 112 (b) (7), to avoid the concurrent dividend tax prescribed by subparagraph (E) of that section as a condition to obtaining those benefits.

It is true that in *Reed Drug Co.* the transferor corporation, rather than its stockholders, was the immediate recipient of the stock of the transferee. But, this stock was distributed by the transferor to its stockholders within three months of the intercorporate exchange, whereupon the transferor was liquidated; and, significantly, the court viewed these steps (p. 289) as integral parts of the same transaction for the purposes of determining the fate of the transferor's earnings and profits. Invoking *Sansome, Kauffmann,* and *Murchison's Estate,* the court in *Reed* held that (p. 290) "the accumulated profits or earned surplus of the *liquidated* corporation pass to the *successor* corporation with the same status and are available for the payment of dividends by the suc-

cessor." (Italics supplied.) The same principle was applied in *Robinette* v. *Commissioner,* 148 F. 2d 513 (C. A. 9th), where it was held that upon the complete liquidation of a subsidiary its accumulated earnings and profits were inherited by the parent. Since Investment was not liquidated contemporaneously with or as one of the steps in a tax-free exchange transaction, but merely substituted the stock of Motors for some of its assets and continued operations for two and one-half years after the exchange, the court below was fully justified in distinguishing the situation here presented from those involved in the *Sansome, Reed,* and like cases.

Taxpayers also rely upon Tax Court and District Court cases where, although the transferor corporation transferred only a portion of its assets and remained in existence, the courts held that a portion of its accumulated earnings and profits should be allocated to the transferee. *Mandel* v. *Commissioner,* 5 T. C. 684; *Estate of McClintic* v. *Commissioner,* 47 B. T. A. 188; and *Barnes* v. *United States,* 22 F. Supp. 282 (E. D. Pa.). But these cases are also distinguishable from the case at bar by an important factual difference. There the stock of the transferee corporation, issued in exchange for a portion of the transferor's assets, was issued to the *stockholders* of the transferor. In effect, the total assets out of which distributions could thereafter be made to such stockholders were divided between the transferor and transferee corporations. Under such circumstances, the Commissioner contended, and the courts properly agreed, that a corresponding allocation of the trans-

feror's earnings and profits was "proper," in the language of the Regulations.

By contrast, the case at bar presents, as noted above, a situation wherein there has been a mere substitution of corporate assets in the hands of Investment, without any diminution whatever of Investment's net worth. Taxpayers cite no authority which, on such facts, requires an allocation of earnings and profits. The authorities which taxpayers do cite required an allocation under other circumstances which, for reasons which are inapplicable here, made such an allocation necessary or appropriate.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

HARRY BAUM,
GRANT W. WIPRUD,
Attorneys.

JUNE 1958.

APPENDIX

Internal Revenue Code of 1939:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges Solely in Kind.*—

* * * * *

(4) *Same.—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) [As amended by Sec. 213 (c), Revenue Act of 1939, c. 247, 53 Stat. 862] *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property

or money") shall be considered as stock or securities received by such transferor.

* * * * *

(7) [As added by Sec. 120 (a), Revenue Act of 1943, c. 63, 58 Stat. 21, and as amended by Sec. 206 (a), Revenue Act of 1950, c. 994, 64 Stat. 906] *Election as to recognition of gain in certain corporate liquidations.*—

(A) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after December 31, 1950, whether the taxable year of the corporation began on, before, or after January 1, 1951; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month in 1951—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subparagraphs (E) and (F).

* * * * *

(E) *Noncorporate Shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subparagraph (A) (ii), but without diminution by reason of distributions made during such month; but by including in the computation

thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after August 15, 1950, exceeds his ratable share of such earnings and profits.

* * * * *

(g) [As amended by Sec. 213 (b), Revenue Act of 1939, *supra,* and Sec. 121 (d) (4), Revenue Act of 1943, *supra*] *Definition of Reorganization.*—As used in this section (other than subsection (b) (10) and subsection (l) and in section 113 (other than subsection (a) (22))—

(1) The term "reorganization" means * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred * * *.

* * * * *

(26 U. S. C. 1952 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Sec. 166, Revenue Act of 1942, c. 619, 56 Stat. 798, and Sec. 1, Act of June 25, 1947, c. 144, 61 Stat. 179] *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earn-

ings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. In the case of a corporation which, under the law applicable to the taxable year in which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504 (c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income, less the sum of the following:

(1) The net operating loss credit provided in section 26 (c) (1);

(2) The dividend carry-over provided in section 27 (c); and

(3) The deduction for amounts for retirement of indebtedness provided in section 504 (b).

* * * * *

(26 U. S. C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.115–11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain

or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1958